RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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February 26, 1986 LETTER 933

Feb. 14 DJIA 1664.45; PTI 2137; A-D Ratio -8.42
Feb. 21 DJIA 1697.71; PTI 2155; A-D Ratio -7.58

THE MARKET: One thing we market veterans might remember is this: bull markets tend to run further than anyone thinks possible. Forgetting this, we conservative old-timers tend to sell out too soon. So far, I've been resisting that temptation. On February 18 crude oil broke below $15 a barrel, while stocks and bonds hit new highs. Said economist Gary Shilling: "We're in a bond rally of a lifetime." He's right.

The bond market obviously adores the deflationary implications of the oil collapse, the stock market loves the lower interest rate levels brought on by the bond rally, and the economy will soon start to reflect the trillions of dollars in increased assets being piled up by this great stock/bond boom.

Because of all the sensational and headline-making action of the various popular stock averages, not too much attention has been paid to the advance-decline ratio. But I have long been a student of the A-D, and I consider this indicator one of the most important of all. The A-D ratio measures the advancing or declining tendency of ALL the stocks on the NYSE. And there is nothing, repeat NOTHING, more bullish than a major and extended rise in the NYSE A-D ratio.

What has all this got to do with today's market? Plenty! We are again seeing a "buying stampede" on Wall Street. I define a buying stampede (and I have written about this many times in the past) as any rise in the A-D ratio of five points or more without so much as one point intervening correction. In other words, a buying stampede is literally an uninterrupted rise of five or more points in the A-D ratio. These buying stampedes are fairly rare, and three or four years may go by without a stampede appearing.

Buying stampedes usually occur in clusters of two or more. I wrote about this back in January 1985 when the first buying stampede occurred. That stampede took the A-D ratio from a December 13, 1984 low of -21.03 to a Feb. 13, 1985 high of -15.46 -- a rise of 5.57 points on the A-D ratio (see page 2 chart).

From Feb. 13 the A-D dropped to a March 25 low of -17.38, and that drop. of course, ended the buying stampede. From the March 25 low , the A-D turned up again, rising to a July 19 high of -12.47. This was an advance of 4.91 points -- just a tiny fraction short of a second stampede. The A-D then declined to an Oct. 8, 1985 low of -16.23.

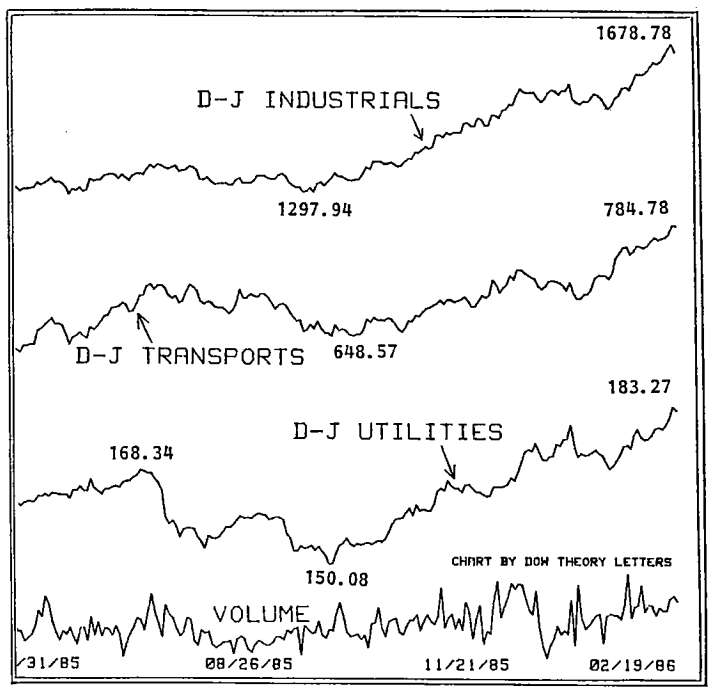
From that Oct. 8 low, the A-D ratio turned up again, and it has continued up to last week's high of -8.75. The October to February rise represented a gain of 7.48 points on the A-D ratio, and so far we have not had a one point intervening decline. Thus the latest buying stampede is still in force.

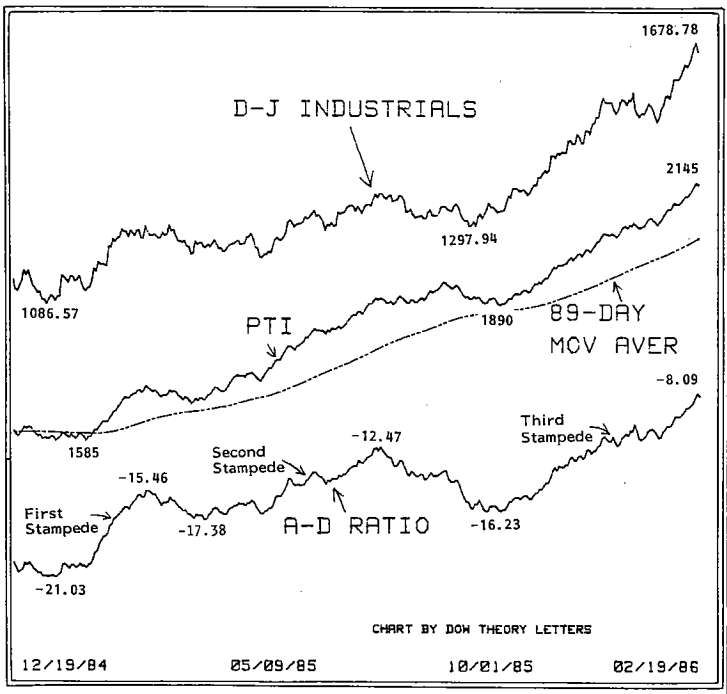
Question: Russell, how does the 1984-85 advance-decline action compare with other A-D rises in the past?

Answer: Although almost all of the major stock averages and indices have climbed to record high levels, the A-D action of the last couple of years has not broken any records. So far, the A-D is up 12.28 points from its December 1984 low. But that performance might even be encouraging, because although the A-D has not produced any records over the last few years, it might yet do so.

For comparison, consider these statistics. In the single year 1932 the A-D rose over 14 points. In the single year 1933 the A-D rose 13 points. Again, in the single year 1935 the A-D climbed a whopping 18 points. In the sensational year 1943 the A-D (during two buying stampedes) rose 19 points. And during 1958 the A-D rose 15 points.

"But," says the protesting bull, "if it had not been for the sad performance of the oil and oil-related stocks on the NYSE, the A-D ratio would now be much higher." That's true, but as I've stated so many times before, I never explain the action of the market away (remember the recent skepticism when General Foods drove the Dow up to record highs?). And I might add that the declining interest rates of 1984 and '85 resulted in steady and powerful action on the part of the preferred issues on the NYSE. Thus, it can be argued that the advancing preferreds (plus the strong action of other interest-sensitive stocks) offset the poor action of the oil-based issues.





Aside from the A-D ratio, one of the items I look for during a primary bull market is broad confirmation on the part of the various averages and indices. On Feb. 14 (Friday) I saw a case of across-the-board confirmation that made me stop and stare. It is seldom, very seldom, that one sees this kind of upside agreement. On that day, all five NYSE indices (Industrial, Transports, Utilities, Finance, Composite) hit record highs. On the same day, the four D-J Averages hit record highs (with the D-J Bond Average hitting a six-year high). Again on that day, the six S&P stock averages all hit new record highs. Thus, the 15 stock averages and indices that I watch most closely ALL hit record highs on Feb. 14. My PTI also hit a record high, while the A-D ratio (NYSE) struck its best level since early-1973.

On Feb. 18 the same list of new records was repeated with all major averages hitting record highs. On top of that, new highs for the year on the NYSE exploded to 452. That 452 figure indicates increasing participation. Markets seldom top out with that kind of action -- rather they tend to top out with decreased participation and divergence in the averages.

Conclusion: We have, since late-1984, been seeing a series of buying stampedes accompanied by new record highs in the major averages. I have made careful and continuing studies of multi-series buying stampedes, and this is what I can report. Following a cluster of two or more stampedes, it is normal to see an extended period of stock market irregularity, sideways movement and even instances of secondary reaction. But in no previous instance did a bear market directly follow a series of true buying stampedes.

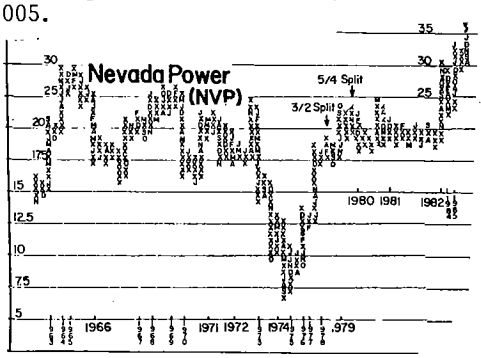
Going back 50 years, the worst case I can find occurred during the 1968-69 period. A double buying stampede ended in November 1968. Then A-D topped out and turned ragged and lower. But the Dow tended to hold, and it even recorded a new (unconfirmed) high in May 1969. That was six months after the A-D high. From May 1969 to June 1970 the market collapsed. But remember, the trouble started a full six months AFTER the end of the second buying stampede.

Conclusion: Buying stampedes in series are very rare. It seems that the powerful fundamental and technical forces that produce multi-series buying stampedes also carry forward for months -- even after the stampedes have ended. During that post-stampede period we have time to gauge the technical position of the market (as to whether it is holding, consolidating, or deteriorating).

INVESTMENT POSITION: The bull is firmly in the box, and the stock market (despite being over-bought) remains highly bullish. NASDAQ was up 11 sessions in a row prior to its first decline on Feb. 19. The bond futures contracts (Treasuries and munis) have broken out to new highs. And all's right with the world (at least the Wall Street world).

There's nothing colder or more objective than the market. Think of it: the oil industry is reeling, the farm industry is in depression, huge bank loans are shaky, but the emotionless verdict of the market is that on balance -- the picture for the nation is bullish! To me, one of the fascinations of the market is its utterly cold, clinical overview.

If chart patterns are significant, I wonder what bullish events are occurring for Nevada Power (NVP)? Here's a powerful pattern, but I don't have any idea what's behind it. On the chart, it's a buy (I do know that the population of tax-free Nevada is booming). Chart courtesy of Market Charts, 20 Exchange Place, NYC 10005.



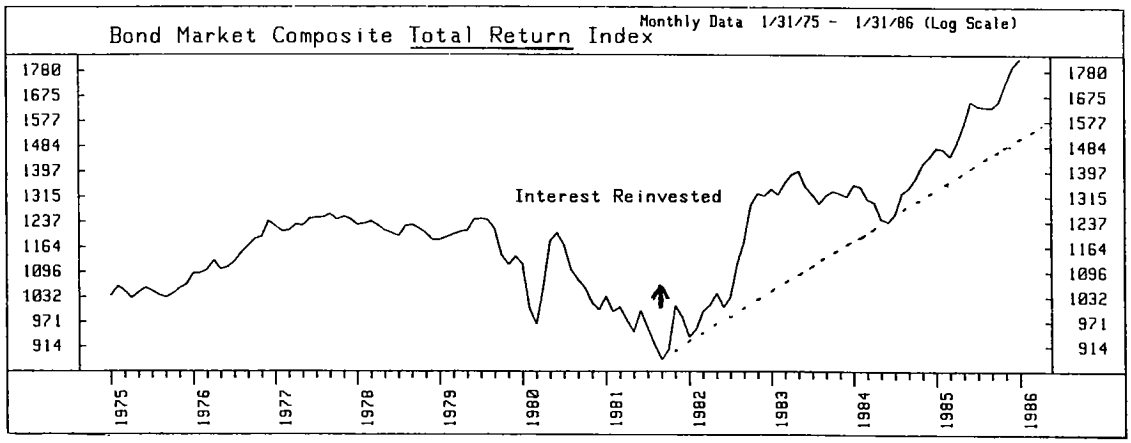
BULL MARKET RETURNS: My late friend, John Magee (a pioneering market technician) used to say, "Don't tell me what to buy -- just tell me when to buy it." In other words, you can invest (or trade) with any stock, bond or commodity, and the difference between making money and losing your shirt boils down to one theme -- are you in a bull or bear market?

This was never clearer than in the bond market. Many sophisticated investors love bonds if bonds can be purchased at the right time. What's the right time for bonds? (1) during a bond bull market, (2) or during a period of sideways bond action.

Bonds in general may possess a few advantages over stocks. The first is that bonds generally provide a much higher rate of return than stocks. Thus, for instance, a bond with a 10% return provides better than twice what the D-J Industrial Average now returns. A second advantage is that some bonds (munis) offer tax-free returns. And as I've written many times, there's no surer way of getting rich than compounding tax-free rates of return.

Sounds easy, doesn't it? It isn't. It's not for a number of reasons. The first is that most people have no patience. And you need patience if you're going to make money with bonds. Second, holding bonds may be boring. There are long periods when bonds do little but pay a return. Next problem: many people buy low-grade bonds and even "junk bonds." Now junk bonds can go belly up and that's just what some of the poorly financed oil company bonds are doing now. So you're not going to make any compounded fortune with bonds that default. Lesson #1: You must buy better-grade bonds if you want to make money compounding over the years. Personally, I never buy bonds rated lower than AA. And I never buy insured bonds.

Lesson #2: I don't care how good a bond you buy, if the bond market is in a bear phase you're going to show paper losses. This chart (courtesy of Ned Davis Research) illustrated that bond picture beautifully. This is a total return index, which means that the index includes both price change plus income. If the bonds yield 9% and the price appreciation is plus 6%, the chart will show a rise of 15%.



If you had bought bonds any time during 1975 through 1981 you would have lost money. Even if you bought a bond with a coupon of say 11% you would have lost money via the bear market action in bonds. The total return, in other words, was negative -- as you can see on the chart.

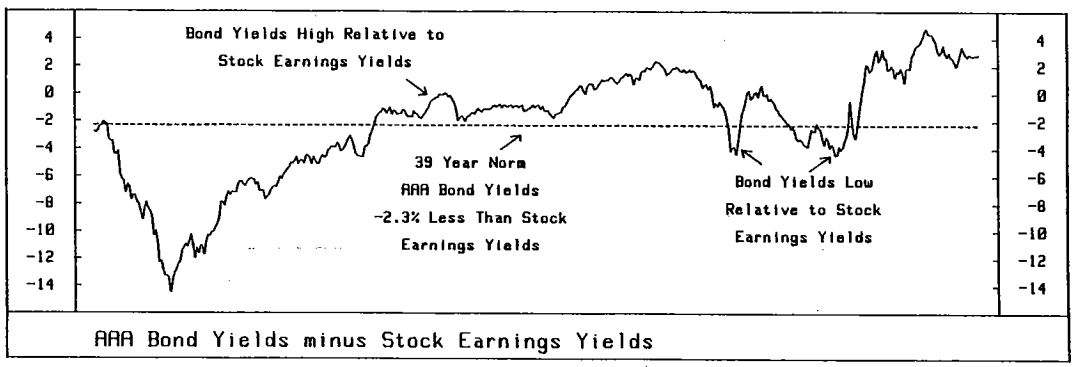
In August of 1981, the total return on bonds hit bottom. From a level of about 910 on the chart, the bond market's total return was thrust upward by two forces: (1) the fat yields on bonds at that time, and (2) the emergence of a real bull market in bonds.

From the 910 level of 1981 the total return index rose to 1790 in late-1985 (it is higher now). Thus the investor who bought bonds in the 1981 period saw his total return more than double. Now there's nothing wrong with doubling your money in a little over four years, and that's what bond buyers who bought during 1981-82 did.

Interestingly, you may remember how bonds were hated during the whole period of 1981, '82, '83 and even into 1984. It's the old story. Few people recognize great values. During 1981-82 Treasury bonds were going at yields of 13 and 14% and good munis were yielding up to 13% tax-free. Those were the bargain days, the days of great value. And value will out -- as this chart on total return graphically demonstrates.

I want to include one more Ned Davis chart here, and this one has to do with stock earnings yields vs. bond yields. Moody's top-grade AAA bond yields are currently around 10%. The earnings yield (not dividend, but earnings yield) for the S&P 500 runs just over 7%. This figure is arrived at by dividing the average earnings on the 500 by the price. So you see that at present, quality bonds still yield better than 2% more than the earnings yield on common stocks (note on the chart that the 39-year norm is minus 2.2%). Thus, at present, bonds still represent great value compared with stocks, despite the big rise in the price of bonds over the last four years.

Let me give you another comparison. The current yield on the high-grade D-J Industrial Average is 3.93%. The current yield on the Bond Buyers Muni Index is 7.73%. Thus dividends on the Dow would have to nearly double to equal what you can get NOW on the muni index. But Dow dividends are taxable and the muni yields are tax-free!



Then why buy stocks at all? The answer: (1) Stocks can adjust for inflation while bonds can not. (2) Stocks can increase earnings and dividends while bonds cannot. But what if we go into a period of disinflation (deflation) and economic recession? If that happens, bonds (and I stress high-grade bonds) are going to be big winners over stocks. And if we go into a period of rising inflation and upward adjusting corporate earnings? In that case you buy stocks. What's the ultimate answer? Probably to diversify. Unless, of course, you're smart enough to identify primary turns in both stocks and bonds.

Where is Russell? I read a lot of advisory services, and one thing I almost never see is what the guy who writes the service does (or did) with his own money. There's an old joke in this business that suggests that few advisors ever make any money in the markets. Well, we just don't know, because what the advisors are doing with their own money isn't -- well, it usually isn't -- mentioned.

So I'm going to break the rule (I have nothing to hide, honest). All during 1982 to the present I have

been buying stocks for my five kids. But I'm in a high tax bracket, and I like tax-free muni income. When the bond market turned up, I began to turn bullish on bonds. And I started buying. I loaded up with a little better than $2 million worth of AA-rated munis (almost all from the state of California). I bought nothing but munis for myself, since I felt that on a yield basis the munis were cheaper than Treasuries (and I wrote that many times). I haven't sold a single bond yet -- I still have the whole darn collection. I figure my paper profit is now pushing around 20% or near $400,000. I'll probably hold the bonds and my kids' stocks until I think the stock and bond markets have both topped out. Right now I'm bullish on both areas, as my subscribers know. So there you are -- "Confessions of a market writer."

DOW COUNTS: The most common question during a bull market (or a bear market, for that matter) is "How far do you think it will go?" And, of course, there is no sure way of answering this question. One of the most basic tenets of classical Dow Theory states, "Neither the duration nor the extent of a primary move can be predicted in advance."

That should hold most investors, but naturally it doesn't. No matter what Dow's Theory or any other theory states, people still want to know how high a bull market is going or how low a bear market is going.

I've done a lot of study in this area, and I've come up with two theses. (1) A primary move usually goes FARTHER than anyone expects. In other words, both bull and bear markets usually surprise people in both their duration and extent. (2) In a bull market the upside "count" via the point & figure method is usually reached. The same thing (on the downside) tends to be true in a bear market.

There are few methods of counting or projecting utilizing P&F analysis. One of the simplest methods (developed by Chartcraft, Larchmont, NY) is the so-called "vertical count." This is based on the thesis that the initial breakout move from a consolidation formation provides information regarding how far the move will ultimately carry. In other words, the force of the initial momentum possesses predictive properties.

Let's study this chart of the Dow and see how the count has worked. This chart is a 10x30 chart which means that each box equals 10 Dow points and only rallies or declines of 30 points or more are shown on the chart.

In August of 1984 the Dow broke out of a consolidation formation (A on chart) and rose 15 boxes or 150 points. Since this is a 3-box reversal chart, it is necessary to multiply the 15 boxes (150 points) by 3 which gives us 450 points. Adding 450 to the bottom of the formation at 1090 gives an upside projection of 1540. And, of course, that 1983 projection has already been fulfilled.

In January 1985 (B on chart) the Dow ran up 14 boxes (140 points) as it rallied from another consolidation pattern. The upside projection here was 3 x 140 or 420 points added to the bottom box of the consolidation formation at 1160. This gave us a new projection of 1580. And that upside projection has been fulfilled.

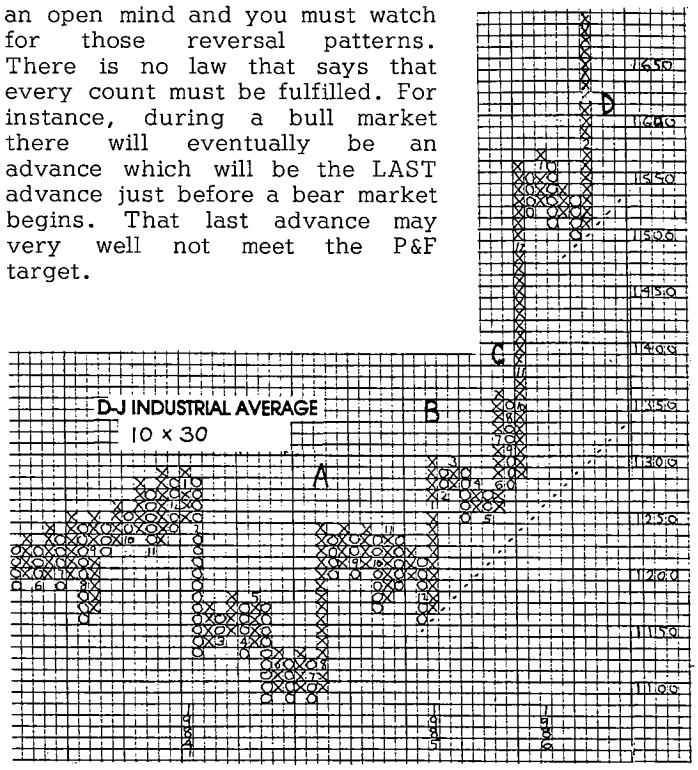
During June and July 1985 the Dow advanced by 11 boxes or 110 points (at C). Multiplying 110 by 3 we get 330 points. This is added to the bottom box of the formation at 1250, providing another upside projection at 1580. So all three projections said that the Dow was heading for the high 1500s! By January 1986 that prediction was fact.

The latest rise (at D) has taken the Dow up **19** boxes or **570** points. Adding this to the bottom of the formation at 1500 we get a new upside projection of **2070** for the Dow. Will this happen? I can't tell for sure, but that is the P&F count. Kind of interesting.

Question: All very well, Russell, but you sound like the P&F count is infallible. What can mess up the count?

Answer: No system is infallible, and I emphasize that the P&F count is always most reliable when the count is in the direction of the major market trend. But every movement (up or down) must have an end, and trees don't grow to the sky. So you have to ask, "At what point do I forget the count and look for a turn?" That point comes when a major reversal formation occurs. But it is not at all unusual to see the count fulfilled and a major reversal pattern being formed at the same time. In other words, it would not be surprising to see the Dow push up toward its high count at **2070** while at the same time the Dow is forming a major top around that figure.

So I feel that the P&F count is fun to calculate and it works in the majority of cases when the count is in harmony with the primary trend. But you must keep an open mind and you must watch for those reversal patterns. There is no law that says that every count must be fulfilled. For instance, during a bull market there will eventually be an advance which will be the LAST advance just before a bear market begins. That last advance may very well not meet the P&F target.



NOTES & QUOTES: Shocker! Writing in the Feb. 11 WSJ, former Assistant Treasury Secretary Paul Roberts notes that both the Congressional Budget Office and the Office of Management and Budget have changed the projections for the deficits. The changes are based on falling interest rates, the effects of the $11.6 billion taken out of the 1986 budget will be cumulative, and defense spending for 1986-89 was reduced by $188 billion The results are shown on page 5.

Current Services Deficit
(in billions)

	1986	*1987*	*1988*	*1989*	*1990*	*1991*
OMB	**206**	**182**	**150**	**139**	**126**	**104**
CBO	**209**	**178**	**164**	**146**	**123**	**107**

If this is true (and I have no reason to believe it is not) then we have a bombshell that few people realize is in the process of exploding. Is this why the stock and particularly the bond markets are heading toward the heavens? It just could be!

* *

Rhea: Don't ask me why, but subscribers seem to like the personal items that appear in these reports. So here's another. A few weeks ago I drove up to LA with my wife, Faye, to visit my ex-father-in-law, Max Lerner (he's the author, educator and newspaper columnist). Max and I are great friends, and I must say that Max is one of the most brilliant men I know. When Max is in LA he stays at the Playboy Mansion with his pal, Hugh Hefner.

So to the Playboy Mansion went Faye and I. Now the Mansion is a many-acred fantasyland situated in the middle of Beverly Hills.It boasts swimming pools, beautiful girls, gorgeous vegetation, and a private zoo with all sorts of birds and animals wandering over its manicured lawn.

Max greeted us and sat us down for some lunch. A few minutes later Hefner walked in and we started an interesting conversation. Next we were joined by Tony Curtis, the actor. Tony sat down and quickly joined the conversation. Whereupon the four of us had a fascinating two-hour session, talking about our lives, our hopes, our marriages, our kids, our fears, our failures and -- you name it.

In the midst of this "group session," I looked up and said to Hefner, "Good lord, I think I see -- could that be -- an ostrich out there on the lawn?" Hef replied, "Close, but it's not an ostrich, it's a South American cousin called a rhea." I was thoroughly taken with this bird and I said, "Faye, grab a camera, I'd like you to take a picture of me and Big Bird." So that's what you see in the picture -- Russell at the Playboy Mansion talking to a rhea. Which, I guess, is no crazier than some of the other items that have appeared here.

* *

To The Desert: On March 19 - 23 ISI is going to present its second Palm Springs Investment Masters Conference. I'll be speaking there along with a gaggle of other guys, including Gerald Ford, Arthur (hopefully Senator) Laffer, Bob Prechter, Stan Weinstein, Bert Dohmen-Ramirez, Charles Allmon and many others. The conference will be put on by my good friends, Charles and Kim Githler, and this conference has one advantage. If you don't like what the speaker is saying, you can walk outside and get a beautiful Palm Springs suntan! But seriously, it should be an interesting seminar, and the Githlers are excellent hosts. For further info , call (813) 365-7691 or write ISI, 1359 Main St., Sarasota, FL 33577.

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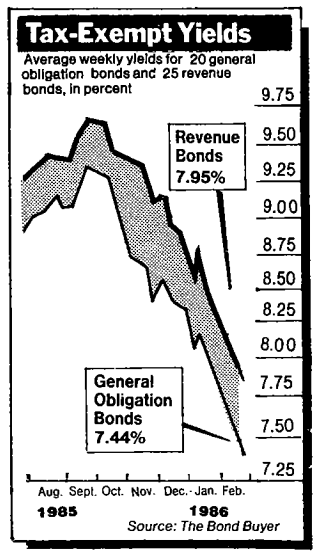
SUNDRY: The widely-watched CRB Commodities Futures Index hit another 7-year low of 211.0 late last week. No question about it, commodities in general are still weak, and the mode is deflationary..... This chart tells the story for bonds. This is an historic collapse for interest rates, and of course, the reverse side of the coin is that bonds have enjoyed an historic rise. ... Institutions don't buy closed-end bond funds as a rule. Thus the bond funds now offer attractive yields. The following on the NYSE should be looked at: American Capital Bond, Transamerica Income, John Hancock Income, John Hancock Securities..... Exxon acts better than the great majority of oils and is still only 10% below its high. With a $3.60 dividend, XON yields 6.9%. With its huge cash flow XON could come out of the oil fiasco in an IMPROVED state. Why? Because XON will very likely buy up reserves (and bankrupt oil companies) at bargain prices. XON buys a good deal of its oil on the open market and also has huge refining and retail capabilities. Cheap oil will be a help in both areas.



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Chow Talk: How do singles meet? Try restaurants. In New Orleans at K-Paul's every seat is filled, and if a guy sits next to a gal, great. NYC is following this idea and at Sandro's and at Wood's Grammercy singles can sit at communal tables. ... Which restaurants do the BIG business? No. 1 in the nation is Hilltop Steak House in Saugus, MA with total sales of over $24 million. Second, NYC's Tavern on the Green with $23 million annually. A distant third is Phillip's Harborplace in Baltimore with $14.7 million. In Southern Calif. the top restaurant is Junior's in LA at $6.3 million. Next is Hard Rock Cafe in West LA at $6 million.

* *

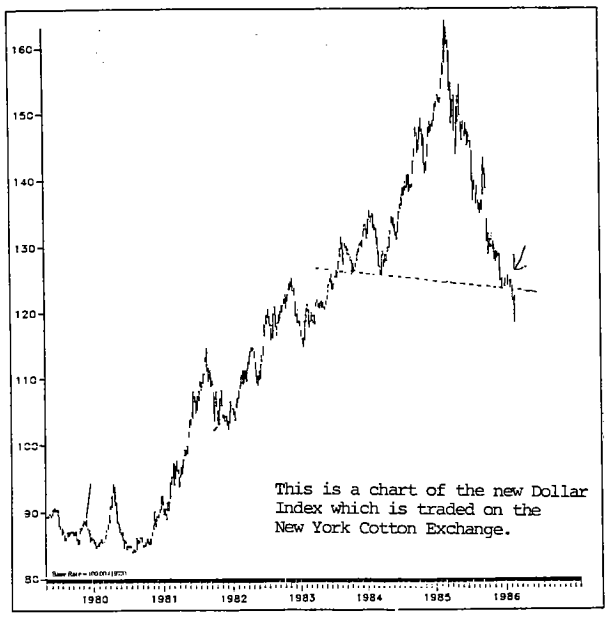
Ah Youth: USA Today interviewed Matty Simmons, founder and board chairman of National Lampoon. Simmons has been around for a long time and has seen a lot of college kids. When asked about today's generation he answered:

> **SIMMONS: The college students now are not only the most boring, for the most part, that we have ever seen, but they are totally without an anxiety to improve the world and to improve their country. They seem to be immersed completely in themselves and how much money they can make and what kind of clothes they can wear and how many sushi bars they can go to. The word "yuppie" is unfortunate, but something has to describe them, and I suppose that does.**

* *

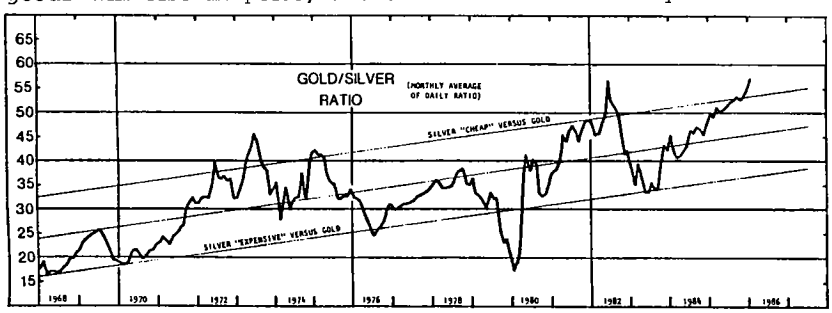
On February 21 the NYSE announced that the latest total short interest was up 10%. Thus the trader's reaction to this powerful market advance is that it is "going too far and the thing to do is to fight it." There is nothing more powerful than a primary bull market that is climbing in the face of increasing skepticism.

GOLD: Back in Letter 930 (Jan. 15) I showed a chart of the new dollar index, and I wrote, "Any rally from



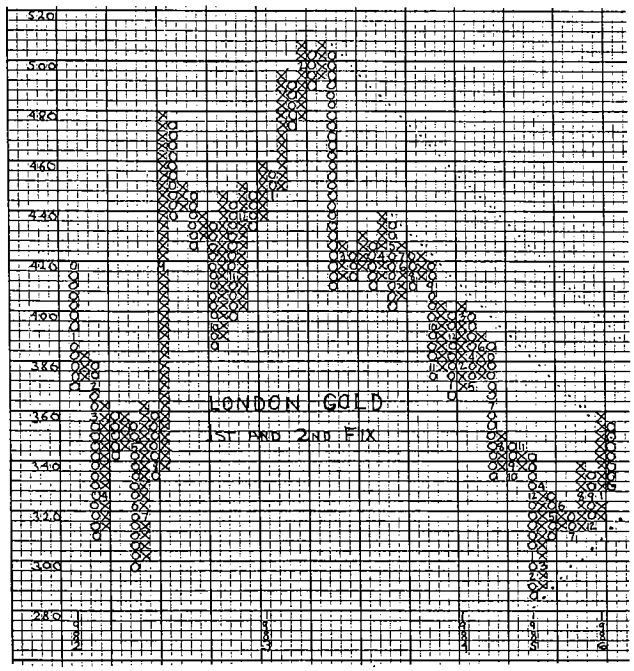
here will form a massive head-and-shoulder top. That's what I'm watching for in the period ahead." Well, we got a little rally (arrow on chart), and from then on it was gangbusters on the downside. The dollar is now down over 30% on the dollar index (the index is a basket of currencies with the yen and the mark heavily weighted).

If the dollar collapse continues a lot of things could happen. (1) Gold could start moving up. (2) Foreign goods will rise in price, and this will be inflationary.



(3) Foreigners could cut back their purchases of Treasury debt. (4) Interest rates in the US could start up again, because foreign buyers will want more yield in return for holding dollars. (5) If the dollar comes down too fast, we could see a panic as dollar holders run for the exits.

OK, there's another interesting phenomenon. For a year now the wise guys have been saying, "Forget gold, buy silver -- that's where the action is." I have disagreed. This chart (courtesy "Deliberations") shows the gold/silver ratio going through the roof in favor of gold.As recently as 1980, you could trade in a 1-ounce gold coin and receive 18 ounces of silver. Now if you have a 1-ounce gold coin you can get darn near 60 ounces of silver! Yeah, silver looks like a bargain compared with gold -- but it's been an



increasing bargain for the past five years. Stay with gold.

What about gold? Personally, I don't think gold has turned bullish on inflationary expectations. I think gold has turned bullish because people with large amounts of dollars are getting a bit nervous about the banks, about oil, about Mexico, about dollars, about the Fed. They're buying gold just in case.

Meanwhile, gold having broken out on my faithful point & figure chart is consolidating. On this chart, gold would have to hit 308 to turn bearish. On a cold appraisal of this chart, gold has turned bullish for the first time since April 1983 (it turned bullish in August 1985), and it has stayed bullish ever since. In fact, the amazing thing is that gold did remain bullish despite the horrendous collapse in oil. Consider this: Last August crude oil was $29 a barrel and gold was 336. Now crude oil is under $15 and gold is around 340. No one would have believed this possible a year ago. But it happened. Gold is marching to a different drummer, and oil isn't beating the drum!

Me, I'm sitting with my gold coins. They don't worry me at all. There are three items on this earth that cannot be substituted for: (1) life, (2) gold, (3) water. Russell suggestion -- hang on to all three of 'em.

LATE NOTES: If you have any kids, take 'em to the nearest boardroom for a look. It may be a long time before they see this market's equal again! Last September 20 the Dow closed at 1297.94. Now, five months later, the Dow has rallied 400 points, up 31%. If you don't own any stocks or bonds by now, I don't know what to tell you. At this point I don't think new buying is investing -- it's chasing the trend (and I know that "the trend is your friend"). Nevertheless, my PTI is at record highs as are almost all the averages. Bonds are soaring and interest rates are dropping. So Russell, how can you still talk about values and perspective? After all, didn't Jack's beanstalk grow to the sky?!

NEXT MAILING: March 12